EXHIBIT 7

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principles of microeconomics

FOURTH EDITION

SOCIAL INSURANCE

The United States has a variety of what are referred to as middle-class **entitlement programs,** so named because individuals do not have to demonstrate poverty to receive benefits. The most important of these are the social insurance programs. Social insurance programs are like private insurance, in that people nominally pay for their own protection through a tax on wage income, the payroll tax. But in other important ways, they are *not* like private insurance, as we will see in the paragraphs that follow.

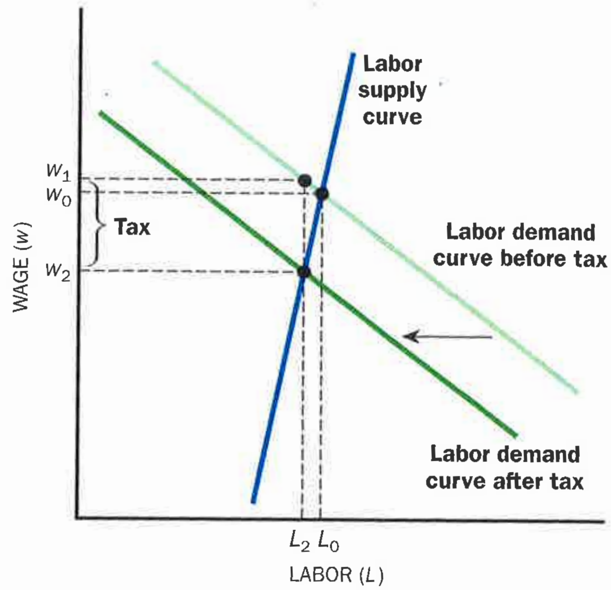

Figure 17.4

THE INCIDENCE OF PAYROLL TAXES

The payroll tax introduces a wedge between the cost to an employer of an individual working an hour more (wage plus tax) and what the worker receives. The magnitude of the wedge does not depend on whether the tax is levied on the employer or employee. The tax leads to fewer workers being hired at the equilibrium wage, reduced from w_0 to w_2.

The Burden of Social Insurance Programs Social Security is supported by a tax on wages, 50 percent paid by the employer and 50 percent by the employee. This division of the tax is entirely superficial; the consequences of the tax are essentially the same as they would be if the worker paid the entire amount.

Figure 17.4 uses demand and supply curves for labor to demonstrate this point. Consider a payroll tax imposed on the employer based on what she pays her workers. The vertical axis measures the wage *received* by the employee. Since the cost of a worker is the wage received by the employee *plus* the tax, the tax shifts the demand curve down. In the new equilibrium, workers' wages have fallen. The wage received by a worker is precisely the same as it would have been had the same tax been imposed on the worker directly. While normally the wage falls by less than the amount of the tax, the extent to which it falls depends on the elasticity of the demand and supply curves. The figure shows the "normal" case where the supply of labor is relatively inelastic, in which case wages fall by almost the full amount of the tax. According to another view, Social Security has relatively little impact on labor supply, by and large, because benefits increase with contributions (though the increase in benefits may not be *fully* commensurate with the increase in contributions); the program is largely a forced savings program. Indeed, most individuals are not forced to save more, or at least much more, than they otherwise would. As we note in the next paragraph, the program has a redistributive aspect. Some individuals therefore receive back less than they contribute, and for them there is a disincentive effect not unlike the disincentive effects that would arise if a similar amount of redistribution occurred through the income tax system.

How Social Insurance Is More Than an Insurance Program In any insurance program, some individuals receive back more than they contribute, others receive less. That is, in a sense, the whole purpose of insurance. David may pay for fire insurance year after year, but if his home never burns down, he doesn't receive anything back from the insurance company. Clara may have the misfortunate to have her house burn down, and may receive back from the insurance company a payment that greatly exceeds what she had paid in. Those lucky enough not to have their houses go up in flames in effect help pay for those who do suffer a loss. Similarly,